

AMENDED IN SENATE JUNE 2, 2003

AMENDED IN SENATE MAY 12, 2003

AMENDED IN SENATE APRIL 21, 2003

SENATE BILL

No. 614

Introduced by Senators Cedillo and Burton

February 20, 2003

An act to amend Sections 18648, 19116, 19164, 19166, 19173, 19177, 19179, 19504, 19715, and 21028 of, to add ~~Sections 17224.7, 18407, and 24344.7~~ *Section 18407* to, and to add Chapter 9.5 (commencing with Section 19751) to Part 10.2 of Division 2 of, the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

SB 614, as amended, Cedillo. Tax shelters.

Existing law imposes various taxes and fees, and certain penalties on late payments of those taxes and fees. Existing law provides specified conformity to federal income tax laws with respect to penalties imposed in connection with tax avoidance and abusive tax shelters.

This bill would, in modified conformity with federal income tax laws, increase the penalties imposed with respect to tax avoidance and abusive tax shelters, as provided.

This bill would require the Franchise Tax Board to develop and administer a voluntary compliance initiative, as specified, to be conducted during the period from January 1, 2004, to March 31, 2004, inclusive, and to apply to tax liabilities attributable to the use of abusive tax avoidance transactions, as specified, for taxable years beginning before January 1, 2004. This would generally authorize a taxpayer utilizing the voluntary compliance initiative to comply, with or without

right to appeal, with the reporting and payment of taxes with respect to a previously filed tax return that used an abusive tax avoidance transaction to underreport tax liability. For a taxpayer who elects to comply without right to appeal, this bill would waive all penalties. For a taxpayer who elects to comply with right to appeal, this bill would waive only the new or increased penalties.

This bill would, except as provided, apply with respect to any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations on assessment has not expired, and would otherwise apply on and after January 1, 2004.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

1 ~~SECTION 1. Section 17224.7 is added to the Revenue and~~
2 ~~Taxation Code, to read:~~

3 ~~17224.7. (a) Section 163 of the Internal Revenue Code,~~
4 ~~relating to deduction for interest, is modified to provide that no~~
5 ~~deduction is allowed under this part for any interest paid or accrued~~
6 ~~on any underpayment of tax that is attributable to either of the~~
7 ~~following:~~

8 ~~(1) The portion of any reportable transaction understatement~~
9 ~~(as defined in subdivision (b) of Section 19773) with respect to~~
10 ~~which the requirement of Section 6664 of the Internal Revenue~~
11 ~~Code, as modified by subdivision (d) of Section 19164, is not met.~~

12 ~~(2) Any noneconomic substance transaction understatement~~
13 ~~(as defined in subdivision (c) of Section 19774).~~

14 ~~(b) This section shall apply to transactions in taxable years~~
15 ~~beginning on or after the effective date of the act adding this~~
16 ~~section.~~

17 ~~SEC. 2.—~~

18 ~~SECTION 1. Section 18407 is added to the Revenue and~~
19 ~~Taxation Code, to read:~~

20 ~~18407. Section 6011 of the Internal Revenue Code, relating to~~
21 ~~general requirement of return, statement, or list, shall apply, except~~
22 ~~as otherwise provided.~~

23 ~~(a) Section 6011(a) of the Internal Revenue Code, relating to~~
24 ~~general rule, is modified as follows:~~

(1) The phrase “any person liable for any tax imposed by Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001) or this part,” shall be substituted for the phrase “when required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title,” contained therein.

(2) “Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or by the Franchise Tax Board” shall be substituted for “Secretary.”

(3) To additionally provide that “reportable transaction” (as defined in paragraph (1) of subdivision (c) of Section 19772) includes any transaction of a type that the Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or the Franchise Tax Board determines as having a potential for tax avoidance or evasion including deductions, basis, credits, entity classification, dividend elimination, or omission of income, and shall be reported on the return or the statement required to be made.

(4) To additionally provide that “listed transaction” (as defined in paragraph (2) of subdivision (c) of Section 19772) includes any transaction that is the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or by the Franchise Tax Board, as a tax avoidance transaction including deductions, basis, credits, entity classification, dividend elimination, or omission of income and shall be reported on the return or statement required to be made.

(A) The Franchise Tax Board shall identify and publish “listed transactions” (whether identified by the Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or by the Franchise Tax Board) through the use of Franchise Tax Board Notices or other published positions. In addition, the “listed transactions” identified and published pursuant to the preceding sentence shall be published on the Web site of the Franchise Tax Board.

(B) The Franchise Tax Board shall conduct a public outreach program to make taxpayers aware of the new and increased penalties associated with the use of tax avoidance transactions

1 including deductions, basis, credits, entity classification, dividend
2 elimination, or omission of income.

3 (5) Chapter 3.5 (commencing with Section 11340) of Part 1 of
4 Division 3 of Title 2 of the Government Code does not apply to any
5 standard, criterion, procedure, determination, rule, notice, or
6 guideline established or issued by the Franchise Tax Board
7 pursuant to paragraph (3) or (4).

8 (b) Section 6011(b) of the Internal Revenue Code, relating to
9 identification of taxpayer, does not apply and, in lieu thereof
10 Section 18408 shall apply.

11 (c) Section 6011(c) of the Internal Revenue Code, relating to
12 returns, etc., of DISCS and former DISCS and FSC's and former
13 FSC's, does not apply.

14 (d) Section 6011(d) of the Internal Revenue Code, relating to
15 authority to require information concerning Section 912
16 allowances, does not apply.

17 (e) Section 6011(e) of the Internal Revenue Code, relating to
18 regulations requiring returns on magnetic media, etc., shall take
19 into account Section 18408 and shall also include the
20 modifications made to Section 6011(e) of the Internal Revenue
21 Code by Section 18408.

22 (f) Section 6011(f)(2) of the Internal Revenue Code, relating to
23 incentives, does not apply.

24 ~~SEC. 3.~~

25 *SEC. 2.* Section 18648 of the Revenue and Taxation Code is
26 amended to read:

27 18648. (a) Any person who is a promoter of tax shelters, as
28 defined in subdivision (c), shall, within 60 days of a request, make
29 a complete return to the Franchise Tax Board containing the full
30 identification of each investment sold during the reporting period.
31 For each investment, all of the following information shall be
32 provided:

33 (1) Name of investment.

34 (2) Description of the business activities of the investment.

35 (3) Form of investment, such as limited partnership, limited
36 liability company, investment plan, or arrangement.

37 (4) A list of investors showing full name, address, social
38 security number, and the amount invested by each investor in the
39 investment during the reporting period.



(5) The total amount invested by all investors during the reporting period in the investment.

(6) Any other related information which the Franchise Tax Board may request.

The return shall be verified by a written declaration that it is made under penalty of perjury.

(b) Every person making a return under subdivision (a) shall furnish, within 60 days of the request, to each investor whose name is set forth in the return a written statement showing all of the following:

(1) The name, address, and telephone number of the person making the return.

(2) The aggregate amount of investments of each investor as shown on that return for each reporting period.

(c) For purposes of this section, the term “a promoter of tax shelters” shall mean any person who:

(1) (A) Organizes (or assists in the organization of) any entity, any investment plan or arrangement, or any other plan or arrangement that generates a loss for any investor in excess of his or her cash investment from an activity described in Section 465(c) of the Internal Revenue Code.

(B) Participates in the sale of any interest in any entity or plan or arrangement referred to in subparagraph (A).

(2) Makes or furnishes (in connection with that organization or sale):

(A) A statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement.

(B) A statement as to the value of any property or services.

(d) A promoter of tax shelters shall keep records necessary to substantiate the information required to be contained on a return.

(e) “Reporting period,” as used in subdivision (a), shall mean each calendar year specified on the request from the Franchise Tax Board.

(f) A return filed by a partnership or limited liability company classified as a partnership for California income tax purposes under this part shall be deemed to have satisfied the reporting requirement of this section for the reporting period covered by the

1 partnership or limited liability company return with respect to the
2 investors in the partnership.

3 (g) The Franchise Tax Board shall establish a review process
4 for all requests for information under this section comparable to
5 the process of obtaining an administrative subpoena under
6 subdivision (c) of Section 19504.

7 ~~SEC. 4.—~~

8 *SEC. 3.* Section 19116 of the Revenue and Taxation Code is
9 amended to read:

10 19116. (a) In the case of an individual who files a return of
11 tax imposed under Part 10 (commencing with Section 17001) for
12 a taxable year on or before the due date for the return, including
13 extensions, if the Franchise Tax Board does not provide a notice
14 to the taxpayer specifically stating the taxpayer's liability and the
15 basis of the liability before the close of the notification period, the
16 Franchise Tax Board shall suspend the imposition of any interest,
17 penalty, addition to tax, or additional amount with respect to any
18 failure relating to the return which is computed by reference to the
19 period of time the failure continues to exist and which is properly
20 allocable to the suspension period.

21 (b) For purposes of this section:

22 (1) Except as provided in subdivision (e), "notification
23 period" means the 18-month period beginning on the later of
24 either of the following:

25 (A) The date on which the return is filed.

26 (B) The due date of the return without regard to extensions.

27 (2) "Suspension period" means the period beginning on the
28 day after the close of the notification period and ending on the date
29 which is 15 days after the date on which notice described in
30 subdivision (a) is provided by the Franchise Tax Board.

31 (c) This section shall be applied separately with respect to each
32 item or adjustment.

33 (d) This section shall not apply to any of the following:

34 (1) Any penalty imposed by Section 19131.

35 (2) Any penalty imposed by Section 19132.

36 (3) Any interest, penalty, addition to tax, or additional amount
37 involving fraud.

38 (4) Any interest, penalty, addition to tax, or additional amount
39 with respect to any tax liability shown on the return.

40 (5) Any criminal penalty.

(e) For taxpayers required by subdivision (a) of Section 18622 to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority the following rules shall apply:

(1) The notification period under subdivision (a) shall be either of the following:

(A) One year from the date the notice required by Section 18622 is filed with the Franchise Tax Board by the taxpayer or the Internal Revenue Service, if the taxpayer or the Internal Revenue Service reports that change or correction within six months after the final federal determination.

(B) Two years from the date when the notice required by Section 18622 is filed with the Franchise Tax Board by the taxpayer or the Internal Revenue Service, if after the six-month period required in Section 18622, a taxpayer or the Internal Revenue Service reports a change or correction.

(2) The suspension period under subdivision (a) shall mean the period beginning on the day after the close of the notification period under paragraph (1) and ending on the date which is 15 days after the date on which notice described in subdivision (a) is provided by the Franchise Tax Board.

(f) For notices sent after January 1, 2004, this section does not apply to taxpayers with taxable income greater than two hundred thousand dollars (\$200,000).

(g) This section shall apply to taxable years ending after October 10, 1999.

~~SEC. 5.—~~

SEC. 4. Section 19164 of the Revenue and Taxation Code is amended to read:

19164. (a) (1) An accuracy-related penalty shall be imposed under this part and shall be determined in accordance with Section 6662 of the Internal Revenue Code, relating to imposition of accuracy-related penalty, except as otherwise provided.

(2) With respect to corporations, this subdivision shall apply to all of the following:

(A) All taxable years beginning on or after January 1, 1990.

(B) Any other taxable year for which an assessment is made after July 16, 1991.

(C) For purposes of this section, references in Section 6662(e) of the Internal Revenue Code and the regulations thereunder,

1 relating to treatment of an affiliated group that files a consolidated
2 federal return, are modified to apply to those entities required to
3 be included in a combined report under Section 25101 or 25110.
4 For these purposes, entities included in a combined report pursuant
5 to paragraph (4) or (6) of subdivision (a) of Section 25110 shall be
6 considered only to the extent required to be included in the
7 combined report.

8 (3) Section 6662(d)(1)(B) of the Internal Revenue Code is
9 modified to provide that in the case of a corporation other than an
10 S corporation, there is a substantial understatement of tax for any
11 taxable year if the amount of the understatement for the taxable
12 year exceeds the lesser of:

13 (A) Ten percent of the tax required to be shown on the return
14 for the taxable year (or, if greater, two thousand five hundred
15 dollars (\$2,500)), or

16 (B) Five million dollars (\$5,000,000).

17 (4) Section 6662(d)(2)(A) of the Internal Revenue Code is
18 modified to additionally provide that the excess determined under
19 Section 6662(d)(2)(A) of the Internal Revenue Code shall be
20 determined without regard to items to which Section 19773
21 applies and without regard to items with respect to which a penalty
22 is imposed by Section 19774.

23 (5) Section 6662(d)(2)(B)(i) of the Internal Revenue Code is
24 modified to substitute the phrase “the tax treatment of any item by
25 the taxpayer if the taxpayer had reasonable belief that the tax
26 treatment was more likely than not the proper treatment” for the
27 phrase “the tax treatment of any item by the taxpayer if there is or
28 was substantial authority for such treatment” contained therein.

29 (b) For purposes of Section 6662(d) of the Internal Revenue
30 Code, Section 6664 of the Internal Revenue Code (as modified by
31 subdivision (d)), Section 6694(a)(1) of the Internal Revenue Code,
32 and this part, the Franchise Tax Board may prescribe a list of
33 positions for which the Franchise Tax Board believes there is not
34 substantial authority or there is no reasonable belief that the tax
35 treatment is more likely than not the proper tax treatment. That list
36 (and any revisions thereof) shall be published through the use of
37 Franchise Tax Board Notices or other published positions. In
38 addition, the “listed transactions” identified and published
39 pursuant to the preceding sentence shall be published on the Web
40 site of the Franchise Tax Board.

1 (c) A fraud penalty shall be imposed under this part and shall
2 be determined in accordance with Section 6663 of the Internal
3 Revenue Code, relating to imposition of fraud penalty, except as
4 otherwise provided.

5 (d) Section 6664 of the Internal Revenue Code, relating to
6 definitions and special rules, shall apply, except as otherwise
7 provided.

8 (1) Section 6664 of the Internal Revenue Code is modified to
9 additionally provide that no penalty shall be imposed under
10 Section 19773 with respect to any portion of a reportable
11 transaction understatement if it is shown that there was a
12 reasonable cause for that portion and that the taxpayer acted in
13 good faith with respect to that portion.

14 (2) Paragraph (1) does not apply to any reportable transaction
15 understatement unless all of the following requirements are met:

16 (A) (i) The relevant facts affecting the tax treatment of the
17 item are adequately disclosed in accordance with the regulations
18 prescribed under Section 6011 of the Internal Revenue Code, as
19 modified by Section 18407.

20 (ii) A taxpayer failing to adequately disclose in accordance
21 with Section 6011 of the Internal Revenue Code, as modified by
22 Section 18407, shall be treated as meeting the requirements of this
23 subparagraph, if the penalty for that failure was rescinded under
24 subdivision (d) of Section 19772.

25 (B) There is or was substantial authority for that treatment.

26 (C) The taxpayer reasonably believed that that treatment was
27 more likely than not the proper treatment.

28 (3) For purposes of subparagraph (C) of paragraph (2) all of the
29 following shall apply:

30 (A) A taxpayer shall be treated as having a reasonable belief
31 with respect to the tax treatment of an item only if that belief meets
32 both of the following requirements:

33 (i) Is based on the facts and law that exist at the time the return
34 of tax that includes that tax treatment is filed.

35 (ii) Relates solely to the taxpayer's chances of success on the
36 merits of that treatment and does not take into account the
37 possibility that the return will not be audited, that the treatment
38 will not be raised on audit, or that the treatment will be resolved
39 through settlement if it is raised.

1 (B) (i) An opinion of a tax advisor may not be relied upon to
2 establish the reasonable belief of a taxpayer if either of the
3 following conditions are met:
4 (I) The tax advisor is described in clause (ii).
5 (II) The opinion is described in clause (iii).
6 (ii) A tax advisor is described in this clause if the tax advisor
7 meets any of the following conditions:
8 (I) Is a material advisor (within the meaning of paragraph (1)
9 of subdivision (b) of Section 19775) who participates in the
10 organization, management, promotion, or sale of the transaction
11 or who is related (within the meaning of Sections 267(b) or
12 707(b)(1) of the Internal Revenue Code) to any person who so
13 participates.
14 (II) Is compensated directly or indirectly by a material advisor
15 with respect to the transaction.
16 (III) Has a fee arrangement with respect to the transaction that
17 is contingent on all or part of the intended tax benefits from the
18 transaction being sustained.
19 (IV) As determined under regulations prescribed by either the
20 Secretary of the Treasury for federal income tax purposes or the
21 Franchise Tax Board, has a continuing financial interest with
22 respect to the transaction.
23 (iii) For purposes of clause (i), an opinion is disqualified if the
24 opinion meets any of the following conditions:
25 (I) Is based on unreasonable, factual, or legal assumptions
26 (including assumptions as to future events).
27 (II) Unreasonably relies on representations, statements,
28 findings, or agreements of the taxpayer or any other person.
29 (III) Does not identify and consider all relevant facts.
30 (IV) Fails to meet any other requirement as either the Secretary
31 of the Treasury for federal income tax purposes or the Franchise
32 Tax Board may by forms and instructions prescribe.
33 (e) Section 6665 of the Internal Revenue Code, relating to
34 applicable rules, shall apply, except as otherwise provided.
35 (f) Section 461(i)(3)(C) of the Internal Revenue Code is
36 modified by substituting a reference to “Section 1274(b)(3)(B) of
37 the Internal Revenue Code, as modified by subdivision (g) of
38 Section 19164” instead of the reference to “Section
39 6662(d)(2)(C)(iii)” contained therein.



(g) Section 1274(b)(3)(B)(i) of the Internal Revenue Code is modified to provide that for purposes of Section 1274(b)(3)(B) of the Internal Revenue Code, the term “tax shelter” means (1) a partnership or other entity, (2) any investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax or the tax imposed under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001).

~~SEC. 6.~~

SEC. 5. Section 19166 of the Revenue and Taxation Code is amended to read:

19166. A penalty shall be imposed for understatement of any taxpayer’s liability by a tax return preparer. The penalty shall be determined in accordance with Section 6694 of the Internal Revenue Code, except as otherwise provided.

(a) (1) Section 6694(a) of the Internal Revenue Code is modified to substitute “one thousand dollars (\$1,000)” for “two hundred fifty dollars (\$250).”

(2) Section 6694(a)(1) of the Internal Revenue Code is modified to substitute the phrase “reasonable belief that the tax treatment in that position was more likely than not the proper treatment” instead of the phrase “realistic possibility of being sustained on its merits” contained therein.

(3) Section 6694(a)(3) of the Internal Revenue Code is modified to substitute the phrase “or there was no reasonable basis for the tax treatment of that position” instead of the phrase “or was frivolous” contained therein.

(b) Section 6694(b) of the Internal Revenue Code is modified to substitute “\$5,000” for “\$1,000.”

(c) Section 6694(c) of the Internal Revenue Code shall not apply and, in lieu thereof, the following shall apply:

(1) If, within 30 days after the day on which notice and demand of any penalty under Section 6694(a) or 6694(b) of the Internal Revenue Code is made against any person who is an income tax return preparer, that person pays an amount which is not less than 15 percent of the amount of that penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of that penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as

1 provided in paragraph (2). Notwithstanding Section 19381, the
2 beginning of that proceeding or levy during the time that
3 prohibition is in force may be enjoined in a proceeding in the
4 superior court.

5 (2) If, within 30 days after the day on which a claim for refund
6 of any partial payment of any penalty under Section 6694(a) or
7 6694(b) of the Internal Revenue Code is denied (or, if earlier,
8 within 30 days after the expiration of six months after the day on
9 which the claim for refund has been filed), the income tax return
10 preparer fails to begin a proceeding in the superior court for the
11 determination of his or her liability for that penalty, paragraph (1)
12 shall cease to apply with respect to that penalty, effective on the
13 day following the close of the applicable 30-day period referred to
14 in this subdivision.

15 (3) The running of the period of limitations provided in Section
16 19371 on the collection by levy or by a proceeding in court in
17 respect of any penalty described in paragraph (1) shall be
18 suspended for the period during which the Franchise Tax Board is
19 prohibited from collecting by levy or a proceeding in court.

20 ~~SEC. 7.~~

21 *SEC. 6.* Section 19173 of the Revenue and Taxation Code is
22 amended to read:

23 19173. (a) If any person required to file a return under
24 Section 18648 or 19775, or maintain a list under Section 19776,
25 for any calendar year does any of the following: (1) fails to file a
26 return within 60 days of a request, or in the case of a return required
27 to be filed under Section 19775, fails to file the return on or before
28 the date prescribed therefor, or in the case of a list required to be
29 maintained under Section 19776, fails to make that list available
30 upon written request therefor by the Franchise Tax Board, (2) files
31 a return which fails to show the information required under
32 Section 18648 or Section 19775, or in the case of a list required to
33 be maintained under Section 19776, fails to show the information
34 required under Section 19776, (3) files false or incomplete
35 information with respect to a reportable transaction required to be
36 filed under Section 19775, or (4), fails to furnish the required
37 statement to each investor, that person shall be liable for a penalty
38 determined under subdivision (b), unless it is shown that
39 subdivision (d) applies.

(b) (1) For purposes of subdivision (a), the amount determined under this subdivision is the product of one thousand dollars (\$1,000), multiplied by the number of investors required to be shown on the return required to be filed under Section 18648. If the number of investors cannot be determined by the Franchise Tax Board, the amount determined under this subdivision shall be one hundred thousand dollars (\$100,000).

(2) (A) For purposes of subdivision (a), the amount determined under this subdivision for a return required to be filed under Section 19775 shall, except as provided in subparagraph (B), be fifteen thousand dollars (\$15,000).

(B) If the penalty is with respect to a listed transaction (as defined in paragraph (2) of subdivision (c) of Section 19772), the amount determined under this subdivision for a return required to be filed under Section 19775 shall be the greater of:

- (i) Two hundred thousand dollars (\$200,000).
- (ii) Fifty percent of the gross income of that material advisor derived from that advice.

(C) In the case of intentional disregard by a material advisor of the requirement to disclose a listed transaction (as defined in paragraph (2) of subdivision (c) of Section 19772) the percentage of gross income under clause (ii) of subparagraph (B) shall be “75 percent” instead of “50 percent.”

(3) For purposes of subdivision (a), the amount determined under this subdivision for the failure to provide a list required to be maintained under Section 19776 at the written request of the Franchise Tax Board shall be ten thousand dollars (\$10,000) for each day after the 20th day that the material advisor has failed to make the list available to the Franchise Tax Board after written request for that list was made by the Franchise Tax Board.

(c) The penalty imposed by subdivision (a) shall be assessed against that person required to file a return under Section 18648, Section 19775, or maintain a list under Section 19776.

(d) (1) The Chief Counsel of the Franchise Tax Board may rescind all or any portion of any penalty imposed by subdivision (a) with respect to any violation with respect to a return required to be filed under Section 18648, Section 19775, or a list required to be maintained under Section 19776 if all of the following apply:

(A) The violation is with respect to a reportable transaction (as defined in paragraph (1) of subdivision (c) of Section 19772) other

1 than a listed transaction (as defined in paragraph (2) of subdivision
2 (c) of Section 19772).

3 (B) The person on whom the penalty is imposed has a history
4 of complying with the requirements of this part and Part 10
5 (commencing with Section 17001) or Part 11 (commencing with
6 Section 23001).

7 (C) It is shown that the violation is due to an unintentional
8 mistake of fact.

9 (D) Imposing the penalty would be against equity and good
10 conscience.

11 (E) Rescinding the penalty would promote compliance with the
12 requirements of this part and Part 10 (commencing with Section
13 17001) or Part 11 (commencing with Section 23001) and effective
14 tax administration.

15 (2) The exercise of authority under paragraph (1) shall be at the
16 sole discretion of the Chief Counsel of the Franchise Tax Board
17 and may not be delegated.

18 (3) Notwithstanding any other law or rule of law, any
19 determination under this subdivision may not be reviewed in any
20 administrative or judicial proceeding.

21 (e) Article 3 (commencing with Section 19031) of this chapter
22 (relating to deficiency assessments) shall not apply with respect to
23 the assessment or collection of any penalty imposed by
24 subdivision (a).

25 (f) The penalty imposed by this section is in addition to any
26 penalty imposed under Part 10 (commencing with Section 17001),
27 Part 11 (commencing with Section 23001), or this part.

28 ~~SEC. 8.—~~

29 *SEC. 7.* Section 19177 of the Revenue and Taxation Code is
30 amended to read:

31 19177. (a) A penalty shall be imposed for promoting abusive
32 tax shelters. The penalty shall be determined in accordance with
33 the provisions of Section 6700 of the Internal Revenue Code,
34 except as otherwise provided.

35 (b) Notwithstanding Section 6700(a) of the Internal Revenue
36 Code, if an activity with respect to which a penalty imposed under
37 Section 6700(a) of the Internal Revenue Code involves a statement
38 described in Section 6700(a)(2)(A) of the Internal Revenue Code,
39 the amount of the penalty imposed under subdivision (a) shall be

1 equal to 50 percent of the gross income derived (or to be derived)
2 from that activity by the person on which the penalty is imposed.

3 ~~SEC. 9.—~~

4 *SEC. 8.* Section 19179 of the Revenue and Taxation Code is
5 amended to read:

6 19179. A penalty shall be imposed for filing a frivolous
7 return. The penalty shall be determined in accordance with Section
8 6702 of the Internal Revenue Code, except as otherwise provided.

9 (a) Section 6702 of the Internal Revenue Code shall be applied
10 to returns required to be filed under this part.

11 (b) Section 6702(a) of the Internal Revenue Code is modified
12 as follows:

13 (1) By substituting “\$5,000” instead of “\$500.”

14 (2) By substituting the phrase “person” instead of the phrase
15 “individual” in each place that it appears.

16 (3) By substituting “tax imposed under Part 10 (commencing
17 with Section 17001), Part 11 (commencing with Section 23001)
18 or this part” instead of the phrase “tax imposed by subtitle A”
19 contained therein.

20 (4) By substituting the phrase “is based on” instead of the
21 phrase “is due to” contained therein.

22 (5) By substituting the phrase “frivolous or is based on a
23 position that the Franchise Tax Board has identified as frivolous
24 under subdivision (c) of Section 19179” instead of the phrase
25 “frivolous” contained therein.

26 (6) By substituting the phrase “reflects a desire to delay or
27 impede the administration of federal income tax laws as
28 determined by the Secretary of the Treasury or the administration
29 of the tax imposed under Part 10 (commencing with Section
30 17001), Part 11 (commencing with Section 23001) or this part as
31 determined by the Franchise Tax Board” instead of the phrase “a
32 desire (which appears on the purported return) to delay or impede
33 the administration of Federal income tax laws” contained therein.

34 (c) (1) The Franchise Tax Board shall prescribe (and
35 periodically revise) a list of positions which the Secretary of the
36 Treasury for federal income tax purposes or the Franchise Tax
37 Board has identified as being frivolous for purposes of this section.

38 (2) Chapter 3.5 (commencing with Section 11340) of Part 1 of
39 Division 3 of Title 2 of the Government Code does not apply to any
40 standard, criterion, procedure, determination, rule, notice, or

1 guideline established or prescribed by the Franchise Tax Board
2 pursuant to paragraph (1).

3 (d) (1) Except as provided in paragraph (3), any person who
4 submits a specified frivolous submission shall pay a penalty of five
5 thousand dollars (\$5,000).

6 (2) For purposes of this section, all of the following shall apply:

7 (A) The term “specified frivolous submission” means a
8 specified submission if any portion of that submission meets any
9 of the following conditions:

10 (i) Is based on a position which the Franchise Tax Board has
11 identified as frivolous under subdivision (c).

12 (ii) Reflects a desire to delay or impede the administration of
13 federal income tax laws as determined by the Secretary of the
14 Treasury or the administration of the tax imposed under Part 10
15 (commencing with Section 17001), Part 11 (commencing with
16 Section 23001) or this part as determined by the Franchise Tax
17 Board.

18 (B) The term “specified submission” means any of the
19 following:

20 (i) A protest under Section 19041.

21 (ii) A request for a hearing under Section 19044.

22 (iii) An application under any of the following sections:

23 (I) Section 19008 (relating to agreements for payment of tax
24 liability in installments).

25 (II) Section 19443 (relating to compromises).

26 (III) Section 21004 (relating to actions of the Taxpayer Right’s
27 Advocate).

28 (3) If the Franchise Tax Board provides a person with notice
29 that a submission is a specified frivolous submission and the
30 person withdraws that submission within 30 days after the notice,
31 the penalty imposed under paragraph (1) does not apply with
32 respect to that submission.

33 (e) (1) The Chief Counsel of the Franchise Tax Board may
34 rescind all or any portion of any penalty imposed by this section
35 if both of the following apply:

36 (A) Imposing the penalty would be against equity and good
37 conscience.

38 (B) Rescinding the penalty would promote compliance with
39 the requirements of this part and Part 10 (commencing with



1 Section 17001) or Part 11 (commencing with Section 23001) and
2 effective tax administration.

3 (2) The exercise of authority under paragraph (1) shall be at the
4 sole discretion of the Chief Counsel of the Franchise Tax Board
5 and may not be delegated.

6 (3) Notwithstanding any other law or rule of law, any
7 determination under this subdivision may not be reviewed in any
8 administrative or judicial proceeding.

9 (f) The penalties imposed by this section shall be in addition to
10 any other penalty provided by law.

11 ~~SEC. 10.~~

12 *SEC. 9.* Section 19504 of the Revenue and Taxation Code is
13 amended to read:

14 19504. (a) The Franchise Tax Board, for the purpose of
15 administering its duties under this part, including ascertaining the
16 correctness of any return; making a return where none has been
17 made; determining or collecting the liability of any person in
18 respect of any liability imposed by Part 10 (commencing with
19 Section 17001), Part 11 (commencing with Section 23001), or this
20 part (or the liability at law or in equity of any transferee in respect
21 of that liability); shall have the power to require by demand, that
22 an entity of any kind including, but not limited to, employers,
23 persons, or financial institutions provide information or make
24 available for examination or copying at a specified time and place,
25 or both, any book, papers, or other data which may be relevant to
26 that purpose. Any demand to a financial institution shall comply
27 with the California Right to Financial Privacy Act set forth in
28 Chapter 20 (commencing with Section 7460) of Division 7 of Title
29 1 of the Government Code. Information that may be required upon
30 demand includes, but is not limited to, any of the following:

31 (1) Addresses and telephone numbers of persons designated by
32 the Franchise Tax Board.

33 (2) Information contained on Federal Form W-2 (Wage and
34 Tax Statement), Federal Form W-4 (Employee's Withholding
35 Allowance Certificate), or State Form DE-4 (Employee's
36 Withholding Allowance Certificate).

37 (b) The Franchise Tax Board may require the attendance of the
38 taxpayer or of any other person having knowledge in the premises
39 and may take testimony and require material proof for its
40 information and administer oaths to carry out this part.

1 (c) The Franchise Tax Board may issue subpoenas or
2 subpoenas duces tecum, which subpoenas must be signed by any
3 member of the Franchise Tax Board, the Executive Officer of the
4 Franchise Tax Board, or any designee, and may be served on any
5 person for any purpose.

6 (d) Obedience to subpoenas or subpoenas duces tecum issued
7 in accordance with this section may be enforced by application to
8 the superior court as set forth in Article 2 (commencing with
9 Section 11180) of Chapter 2 of Part 1 of Division 3 of Title 2 of
10 the Government Code.

11 (e) When examining a return, the Franchise Tax Board shall not
12 use financial status or economic reality examination techniques to
13 determine the existence of unreported income of any taxpayer
14 unless the Franchise Tax Board has a reasonable indication that
15 there is a likelihood of unreported income. This subdivision
16 applies to any examination beginning on or after October 10, 1999.

17 ~~SEC. 11.~~—

18 *SEC. 10.* Section 19715 of the Revenue and Taxation Code is
19 amended to read:

20 19715. (a) A civil action in the name of the State of California
21 to enjoin any person from further engaging in specified conduct
22 may be commenced at the request of the Franchise Tax Board. Any
23 action under this section shall be brought in accordance with
24 Section 19707. The court may exercise its jurisdiction over that
25 action separate and apart from any other action brought by the
26 State of California against that person.

27 (b) In any action under subdivision (a), the court may enjoin the
28 person from engaging in the specified conduct or in any other
29 activity subject to penalty under this part, if the court finds both of
30 the following:

31 (1) That the person has engaged in any specified conduct.

32 (2) That injunctive relief is appropriate to prevent recurrence
33 of that specified conduct.

34 (c) For purposes of this section, the term “specified conduct”
35 means any action, or failure to take action, subject to penalty under
36 Section 19173, 19174, 19177, or 19178.

37 ~~SEC. 12.~~—

38 *SEC. 11.* Chapter 9.5 (commencing with Section 19751) is
39 added to Part 10.2 of Division 2 of the Revenue and Taxation Code,
40 to read:

CHAPTER 9.5. TAX SHELTERS

19751. (a) The Franchise Tax Board shall develop and administer a voluntary compliance initiative for taxpayers subject to Part 10 (commencing with Section 17001) and Part 11 (commencing with Section 23001), as provided in this chapter.

(b) The voluntary compliance initiative shall be conducted during the period from January 1, 2004, to March 31, 2004, inclusive, pursuant to Section 19754. This initiative shall apply to tax liabilities attributable to the use of abusive tax avoidance transactions for taxable years beginning before January 1, 2004.

(c) The Franchise Tax Board shall issue forms and instructions and may take any other actions necessary, including the use of closing agreements, to implement this chapter.

(d) The Franchise Tax Board shall publicize the voluntary compliance initiative so as to maximize public awareness of and participation in the initiative. The Franchise Tax Board shall coordinate to the highest degree possible its publicity efforts and other actions taken in implementing this chapter.

(e) Any correspondence mailed by the Franchise Tax Board to a taxpayer at the taxpayer's last known address outlining the voluntary compliance initiative under this chapter constitutes "contact" within the meaning of Treasury Regulation Section 1.6664-2(c)(3), relating to qualified amended returns, and paragraph (3) of subdivision (e) of Section 19773 and Section ~~19778~~ 19777, regarding increased interest rate.

19752. Any taxpayer who meets the requirements of Section 19754 may elect the application of either, but not both, of the following:

(a) Voluntary compliance without appeal. If this option is elected, then each of the following shall apply:

(1) The Franchise Tax Board shall waive or abate all penalties imposed by this part, for all taxable years where the taxpayer elects to participate in the initiative, as a result of the underreporting of tax liabilities attributable to the use of abusive tax avoidance transactions.

(2) Except as provided in Section 19753, no criminal action shall be brought against the taxpayer for the taxable years with respect to issues for which the taxpayer voluntarily complies under this chapter.

(3) No penalty may be waived or abated under this chapter if the penalty imposed is attributable to an assessment of taxes that became final prior to December 31, 2003.

(4) Notwithstanding Chapter 6 (commencing with Section 19301) of this part, the taxpayer may not file a claim for refund for the amounts paid in connection with abusive tax avoidance transactions under this chapter.

(b) Voluntary compliance with appeal. If this option is elected, then each of the following shall apply:

(1) The Franchise Tax Board shall waive or abate all penalties, except the accuracy related penalty under Section 19164, imposed by this part, for each of the taxable years for which the taxpayer elects to participate in the initiative, that are owed as a result of the underreporting of tax liabilities attributable to the use of abusive tax avoidance transactions.

(2) Except as provided in Section 19753, no criminal action may be brought against the taxpayer for each of the taxable years for which the taxpayer voluntarily complies under this section.

(3) No penalty may be waived under this chapter if the penalty imposed is attributable to an assessment of taxes that became due and payable prior to December 31, 2003.

(4) The taxpayer may file a claim for refund under Chapter 6 (commencing with Section 19301) of this part. Notwithstanding Section 19331, the taxpayer may not file an appeal to the board until after either of the following:

(A) The date the Franchise Tax Board takes action on the claim for refund for the tax year to which this chapter applies.

(B) The later of either of the following dates:

(i) The date that is 180 days after the date of a final determination by the Internal Revenue Service with respect to the transaction or transactions to which this chapter applies.

(ii) The date that is four years after the date the claim for refund was filed or one year after full payment of all tax, including penalty and interest was made, whichever date is later.

(5) The taxpayer shall be subject to the accuracy related penalty under Section 19164.

(A) The penalty may be assessed:

(i) When the Franchise Tax Board takes action on the claim for refund.

(ii) When a federal determination becomes final for the same issue, in which case the penalty shall be assessed (and may not be abated) if the penalty was assessed at the federal level.

(B) In determining the amount of the underpayment of tax, Treasury Regulation Section 1.6664-2(c)(2), as promulgated under Section 6664 of the Internal Revenue Code, relating to qualified amended returns, shall not apply. The amount of the underpayment is the difference between the amount of tax shown on the original return and the correct amount of tax for the taxable year. The underpayment amount shall not be less than the amount of the claim for refund filed by the taxpayer under paragraph (4) that was denied.

(C) The penalty is due and payable upon notice and demand pursuant to Section 19049. Only after the taxpayer has paid all amounts due, including the penalty, and the claim is denied in whole or in part, may the taxpayer file an appeal under Chapter 6 (commencing with Section 19301), of this part in conjunction with the appeal filed under paragraph (4).

(c) A taxpayer's election under this section shall be made for all taxable years of the taxpayer governed by this chapter. A separate election for each taxable year governed by this chapter is not allowed.

19753. (a) This chapter does not apply to violations of this part for which, as of December 31, 2003, any of the following applies:

(1) A criminal complaint was filed against the taxpayer in connection with an abusive tax avoidance transaction or transactions.

(2) The taxpayer is the subject of a criminal investigation in connection with an abusive tax avoidance transaction or transactions.

(b) No refund or credit shall be granted with respect to any penalty paid prior to the time the taxpayer participates in the voluntary compliance initiative authorized by this chapter.

(c) For purposes of this chapter, an "abusive tax avoidance transaction" means a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, "listed transactions" as described in Section 19772.

19754. (a) This chapter applies to any taxpayer who was not eligible to participate in the Internal Revenue Service's Offshore Voluntary Compliance Initiative described in Revenue Procedure 2003-11, and during the period from January 1, 2004, to March 31, 2004, does both of the following:

(1) Files an amended tax return under this part for each taxable year for which the taxpayer has previously filed a tax return using an abusive tax avoidance transaction to underreport the taxpayer's tax liability for that taxable year. Each amended return shall report all income from all sources, without regard to the abusive tax avoidance transaction.

(2) Except as provided in subdivision (b), pays in full all taxes and interest due.

(b) The Franchise Tax Board may enter into an installment payment agreement in lieu of the full payment required under paragraph (2) of subdivision (a). Any installment payment agreement authorized by this subdivision shall include interest on the unpaid amount at the rate prescribed in Section 19521. Failure by the taxpayer to fully comply with the terms of the installment payment agreement shall render the waiver of penalties null and void, and the total amount of tax, interest, and all penalties shall be immediately due and payable.

(c) After March 31, 2004, the Franchise Tax Board may issue a deficiency assessment upon an amended return filed pursuant to subdivision (a), impose penalties, or initiate criminal action under this part with respect to the difference between the amount shown on that return and the correct amount of tax. This action shall not invalidate any waivers granted under Section 19752.

(d) In addition to any other authority to examine returns, for the purpose of improving state tax administration, the Franchise Tax Board may inquire into the facts and circumstances related to the use of abusive tax avoidance transactions to underreport the tax liabilities for which a taxpayer has participated in the voluntary compliance initiative under this chapter. Taxpayers shall cooperate fully with inquiries described in this subdivision. Failure by a taxpayer to fully cooperate in an inquiry described in this subdivision shall render the waiver of penalties under this chapter null and void and the taxpayer may be assessed any penalties that may apply.

1 19755. (a) Notwithstanding Section 19057, with respect to
2 proposed deficiency assessments related to an abusive tax
3 avoidance transaction, as defined in subdivision (c) of Section
4 19753, a notice of a proposed deficiency assessment may be
5 mailed to the taxpayer within eight years after the return was filed,
6 or within the period otherwise provided in Article 3 (commencing
7 with Section 19031) of Chapter 4 of this part, whichever expires
8 later.

9 (b) This section shall apply to any return filed under this part
10 on or after January 1, 2000.

11 19771. (a) In applying the economic substance doctrine
12 under Part 10 (commencing with Section 17001), Part 11
13 (commencing with Section 23001), and this part, the
14 determination of whether a transaction has economic substance
15 shall be made as provided in this section.

16 (b) For purposes of subdivision (a):

17 (1) A transaction has economic substance only if all of the
18 following apply:

19 (A) The transaction changes in a meaningful way (apart from
20 California state income tax effects and, if there is any California
21 state income tax effects, also apart from any federal, foreign, other
22 state, or local tax effects) the taxpayer's economic position.

23 (B) The taxpayer has a substantial nontax purpose for entering
24 into that transaction and the transaction is a reasonable means of
25 accomplishing that purpose.

26 (2) A transaction may not be treated as having economic
27 substance by reason of having a potential for profit unless both of
28 the following apply:

29 (A) The present value of the reasonably expected pretax profit
30 from the transaction is substantial in relation to the present value
31 of the expected net tax benefits that would be allowed if the
32 transaction were respected.

33 (B) The reasonably expected pretax profit from the transaction
34 exceeds a risk-free rate of return.

35 (c) Fees and other transaction expenses and foreign taxes shall
36 be taken into account as expenses in determining pretax profit
37 under paragraph (2) of subdivision (b).

38 (d) (1) The form of a transaction that is in substance the
39 borrowing of money or the acquisition of financial capital directly
40 or indirectly from a tax-indifferent party may not be respected if

1 the present value of the deductions to be claimed with respect to
2 the transaction is substantially in excess of the present value of the
3 anticipated economic returns of the person lending the money or
4 providing the financial capital. A public offering shall be treated
5 as a borrowing, or an acquisition of financial capital, from a
6 tax-indifferent party if it is reasonably expected that at least 50
7 percent of the offering will be placed with tax-indifferent parties.

8 (2) The form of a transaction with a tax-indifferent party may
9 not be respected if either of the following apply:

10 (A) The form of the transaction results in an allocation of
11 income or gain to the tax-indifferent party in excess of that party's
12 economic income or gain.

13 (B) The form of the transaction results in a basis adjustment or
14 shifting of basis on account of overstating the income or gain of
15 the tax-indifferent party.

16 (e) For purposes of this section:

17 (1) The term "economic substance doctrine" means the
18 common law doctrine under which tax benefits under Part 10
19 (commencing with Section 17001) or Part 11 (commencing with
20 Section 23001) with respect to a transaction are not allowable if the
21 transaction does not have economic substance or lacks a business
22 purpose.

23 (2) The term "tax-indifferent party" means any person or
24 entity not subject to tax imposed by Part 10 (commencing with
25 Section 17001) or Part 11 (commencing with Section 23001)
26 including an entity not subject to tax imposed under Part 11
27 pursuant to a water's edge election under Article 1.5 (commencing
28 with Section 25110) of Chapter 17 of Part 11. A person shall be
29 treated as a tax-indifferent party with respect to a transaction if the
30 items taken into account with respect to the transaction have no
31 substantial impact on that person's liability under Part 10
32 (commencing with Section 17001) or Part 11 (commencing with
33 Section 23001).

34 (3) In applying subparagraph (A) of paragraph (2) of
35 subdivision (b) to the lesser of tangible property subject to a lease,
36 the expected net tax benefits shall not include the benefits of
37 depreciation, or any tax credit, with respect to the leased property
38 and subparagraph (B) of paragraph (2) of subdivision (b) shall be
39 disregarded in determining whether any of those benefits are
40 allowable.



(f) Except as specifically provided in this section, the provisions of this section shall not be construed as altering or supplanting any other rule of law, and the requirements of this section shall be construed as being in addition to any other rule of law.

(g) (1) The Franchise Tax Board may prescribe those regulations as may be necessary or appropriate to carry out the purposes of this section. The regulations may include exemptions from the application of this section.

(2) Any regulations promulgated by the Secretary of the Treasury related to economic substance shall be applicable for purposes of this section to the extent they do not conflict with this part or with regulations issued by the Franchise Tax Board.

(h) This section shall apply to determinations on or after the effective date of this act with respect to transactions entered into on or after January 1, 1999.

19772. (a) Any person who fails to include on any return or statement any information with respect to a reportable transaction that is required under Section 6011 of the Internal Revenue Code, as modified by Section 18407, to be included with that return or statement shall pay a penalty in the amount determined under subdivision (b).

(b) (1) Except as provided in paragraphs (2) and (3), the amount of the penalty under subdivision (a) shall be fifteen thousand dollars (\$15,000).

(2) The amount of the penalty under subdivision (a) with respect to a listed transaction shall be thirty thousand dollars (\$30,000).

(3) (A) In the case of a failure under subdivision (a) by a large entity, or by a high net worth individual, the penalty under paragraph (1) or (2) shall be twice the amount determined without regard to this paragraph.

(B) For purposes of subparagraph (A), the term “large entity” means, with respect to any taxable year, a person (other than an individual) with gross receipts in excess of ten million dollars (\$10,000,000) for the taxable year in which the reportable transaction occurs or the preceding taxable year. Rules similar to the rules of Section 448(c)(2) and 448(c)(3) of the Internal Revenue Code, other than Section 448(c)(3)(A) of the Internal Revenue Code, shall apply for purposes of this subparagraph.

(C) The term “high net worth individual” means, with respect to a transaction, an individual whose net worth exceeds two million dollars (\$2,000,000) immediately before the transaction.

(c) For purposes of this section:

(1) The term “reportable transaction” means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed by the Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or by the Franchise Tax Board under Section 18407, that transaction is of a type that the Secretary of the Treasury for federal income tax purposes or the Franchise Tax Board determines as having a potential for tax avoidance or evasion.

(2) Except as provided in regulations prescribed by the Secretary of the Treasury or by the Franchise Tax Board, the term “listed transaction” means a reportable transaction (as defined in paragraph (1)) that is the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury for purposes of Section 6011 of the Internal Revenue Code for federal income tax purposes or by the Franchise Tax Board for purposes of Section 6011 of the Internal Revenue Code or Section 18407, as a tax avoidance transaction.

(d) (1) The Chief Counsel of the Franchise Tax Board may rescind all or any portion of any penalty imposed by this section with respect to any violation if all of the following apply:

(A) The violation is with respect to a reportable transaction other than a listed transaction.

(B) The person on whom the penalty is imposed has a history of complying with the requirements of this part and Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001).

(C) It is shown that the violation is due to an unintentional mistake of fact.

(D) Imposing the penalty would be against equity and good conscience.

(E) Rescinding the penalty would promote compliance with the requirements of this part and Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) and effective tax administration.

(2) The exercise of authority under paragraph (1) shall be at the sole discretion of the Chief Counsel of the Franchise Tax Board and may not be delegated.

(3) Notwithstanding any other law or rule of law, any determination under this subdivision may not be reviewed in any administrative or judicial proceeding.

(e) Article 3 (commencing with Section 19031) of Chapter 4 (relating to deficiency assessments) shall not apply with respect to the assessment or collection of any penalty imposed under this section.

(f) The penalty imposed by this section is in addition to any penalty imposed under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part.

19773. (a) If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of that understatement.

(b) For purposes of this section, both of the following shall apply:

(1) The term “reportable transaction understatement” means the sum of subparagraphs (A) and (B).

(A) The product of:

(i) The amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer’s treatment of that item (as shown on the taxpayer’s return of tax).

(ii) The highest rate of tax imposed on the taxpayer under Part 10 (commencing with Section 17001) in the case of a taxpayer subject to tax under that part or under Part 11 (commencing with Section 23001) in the case of a taxpayer that is subject to tax under that part.

(B) The amount of the decrease (if any) in the aggregate amount of credits determined under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001), as applicable, that results from a difference between the taxpayer’s treatment of an item to which this section applies (as shown on the taxpayer’s return of tax) and the proper tax treatment of that item.

(C) For purposes of subparagraph (A), any reduction of the excess of deductions allowed for the taxable year over gross income for that year, and any reduction in the amount of capital

1 losses which would (without regard to Section 1211 of the Internal
2 Revenue Code) be allowed for that year, shall be treated as an
3 increase in taxable income.

4 (2) This section shall apply to any item that is attributable to
5 either of the following:

6 (A) Any listed transaction.

7 (B) Any reportable transaction (other than a listed transaction)
8 if a significant purpose of that transaction is the avoidance or
9 evasion of tax imposed under Part 10 (commencing with Section
10 17001) or Part 11 (commencing with Section 23001).

11 (c) (1) Subdivision (a) shall be applied by substituting “30
12 percent” for “20 percent” with respect to the portion of any
13 reportable transaction understatement with respect to which the
14 requirement of Section 6664 of the Internal Revenue Code, as
15 modified by subparagraph (A) of paragraph (2) of subdivision (d)
16 of Section 19164, is not met.

17 (2) (A) If the notice of proposed assessment of additional tax
18 has been sent with respect to a penalty to which this section applies,
19 only the Chief Counsel of the Franchise Tax Board may
20 compromise all or any portion of that penalty.

21 (B) The exercise of authority under subparagraph (A) shall be
22 at the sole discretion of the Chief Counsel of the Franchise Tax
23 Board and may not be delegated.

24 (C) Notwithstanding any other law or rule of law, any
25 determination under this subdivision may not be reviewed in any
26 administrative or judicial proceeding.

27 (d) For purposes of this section, the terms “reportable
28 transaction” and “listed transaction” have the respective
29 meanings given to those terms by subdivision (c) of Section
30 19772.

31 (e) (1) In the case of an understatement (as defined in Section
32 6662(d)(2) of the Internal Revenue Code) all of the following shall
33 apply:

34 (A) The amount of the understatement (determined without
35 regard to this paragraph) shall be increased by the aggregate
36 amount of reportable transaction understatements and
37 noneconomic substance transaction understatements for purposes
38 of determining whether the understatement is a substantial
39 understatement under Section 6662(d)(1) of the Internal Revenue
40 Code.

1 (B) The addition to tax under subdivision (a) of Section 19164
2 shall apply only to the excess of the amount of the substantial
3 understatement (if any) after the application of subparagraph (A)
4 over the aggregate amount of reportable transaction
5 understatements and noneconomic substance transaction
6 understatements.

7 (2) (A) In determining the fraud penalty imposed under
8 subdivision (c) of Section 19164, references to an underpayment
9 in Section 6663 of the Internal Revenue Code shall be treated as
10 including references to a reportable transaction understatement
11 and a noneconomic substance transaction understatement.

12 (B) This section does not apply to any portion of an
13 understatement on which a penalty is imposed under Section
14 19774.

15 (3) Except as provided in regulations, in no event may any tax
16 treatment included with an amendment or supplement to a return
17 of tax be taken into account in determining the amount of any
18 reportable transaction understatement or noneconomic substance
19 transaction understatement, if the amendment or supplement is
20 filed after the earlier of the date the taxpayer is first contacted by
21 either the Secretary of the Treasury for federal income tax
22 purposes or the Franchise Tax Board regarding the examination of
23 the return or such other date as is specified by the Franchise Tax
24 Board.

25 (4) For purposes of this subdivision, the term “noneconomic
26 substance transaction understatement” has the meaning given that
27 term by subdivision (c) of Section 19774.

28 19774. (a) If a taxpayer has a noneconomic substance
29 transaction understatement for any taxable year, there shall be
30 added to the tax an amount equal to 40 percent of the amount of
31 that understatement.

32 (b) (1) Subdivision (a) shall be applied by substituting “20
33 percent” for “40 percent” with respect to the portion of any
34 noneconomic substance transaction understatement with respect
35 to which the relevant facts affecting the tax treatment of the item
36 are adequately disclosed in the return or a statement attached to the
37 return.

38 (2) For taxable years beginning before January 1, 2003,
39 “adequately disclosed” includes the disclosure of the tax shelter

1 identification number on the taxpayer's return as required by
2 subdivision (c) of Section 18628.

3 (c) (1) The term "noneconomic substance transaction
4 understatement" means any amount which would be an
5 understatement under paragraph (1) of subdivision (b) of Section
6 19773 if Section 19773 were applied by taking into account items
7 attributable to noneconomic substance transactions rather than
8 items to which Section 19773 applies.

9 (2) The term "noneconomic substance transaction" means any
10 transaction if either of the following conditions is satisfied:

11 (A) There is a lack of economic substance (within the meaning
12 of Section 19771) for the transaction giving rise to the claimed
13 benefit or the transaction was not respected under Section 19771.

14 (B) The transaction fails to meet the requirements of any
15 similar rule of law.

16 (d) (1) If the notice of proposed assessment of additional tax
17 has been sent with respect to a penalty to which this section applies,
18 only the Chief Counsel of the Franchise Tax Board may
19 compromise all or any portion of that penalty.

20 (2) The exercise of authority under paragraph (1) shall be at the
21 sole discretion of the Chief Counsel of the Franchise Tax Board
22 and may not be delegated.

23 (3) Notwithstanding any other law or rule of law, any
24 determination under this subdivision may not be reviewed in any
25 administrative or judicial proceeding.

26 19775. In addition to the requirements of Section 18628, all
27 of the following requirements apply:

28 (a) (1) Each material advisor with respect to any reportable
29 transaction shall make a return (in the form the Franchise Tax
30 Board may by forms and instructions prescribe) setting forth all of
31 the following:

32 (A) Information identifying and describing the transaction.

33 (B) Information describing any potential tax benefits expected
34 to result from the transaction.

35 (C) Any other information as the Franchise Tax Board may by
36 forms and instructions prescribe.

37 (2) The return required under paragraph (1) shall be filed not
38 later than the date specified by the Franchise Tax Board.

39 (b) For purposes of this section:

1 (1) (A) The term “material advisor” means any person that
2 satisfies both of the following requirements:

3 (i) Provides any material aid, assistance, or advice with respect
4 to organizing, promoting, selling, implementing, or carrying out
5 any reportable transaction.

6 (ii) Directly or indirectly derives gross income in excess of the
7 threshold amount for that aid, assistance, or advice.

8 (B) For purposes of subparagraph (A), the threshold amount is
9 fifty thousand dollars (\$50,000) in the case of a reportable
10 transaction substantially all of the tax benefits from which are
11 provided to individuals, and two hundred fifty thousand dollars
12 (\$250,000) in any other case.

13 (2) The term “reportable transaction” has the meaning given
14 to that term by paragraph (1) of subdivision (c) of Section 19772.

15 (c) The Franchise Tax Board may by forms and instructions
16 prescribe all of the following:

17 (1) That only one person shall be required to meet the
18 requirements of subdivision (a) in cases in which two or more
19 persons would otherwise be required to meet those requirements.

20 (2) Exemptions from the requirements of this section.

21 (3) Those rules as may be necessary or appropriate to carry out
22 the purposes of this section.

23 19776. (a) Each material advisor (as defined in Section
24 19775) with respect to any reportable transaction (as defined in
25 paragraph (1) of subdivision (c) of Section 19772) shall maintain,
26 in the form and manner as the Franchise Tax Board may by forms
27 and instructions prescribe, a list that provides all of the following
28 information:

29 (1) Identification of each person with respect to whom the
30 material advisor acted as a material advisor with respect to a
31 reportable transaction (as defined in paragraph (1) of subdivision
32 (c) of Section 19772). That identification shall include for each
33 person listed, the full name, address, and taxpayer identification
34 number of that person.

35 (2) Contains any other information the Franchise Tax Board
36 may require.

37 (b) Every person required to maintain a list under subdivision
38 (a) shall make that list available to the Franchise Tax Board within
39 20 days of a written request for that list made by the Franchise Tax
40 Board. Every person required to maintain a list under subdivision

(a) shall furnish, within 20 days of the date the list is furnished to the Franchise Tax Board under the preceding sentence, to each person with respect to whom the material advisor acted as a material advisor with respect to a reportable transaction (as defined in paragraph (1) of subdivision (c) of Section 19772) and that is shown on that list, a written statement showing the name, address, and telephone number of the person furnishing the list to the Franchise Tax Board as well as the description of the information provided.

(c) This section applies without regard to whether a material advisor is required to file a return under Section 19775 with respect to a reportable transaction (as defined in paragraph (1) of subdivision (c) of Section 19772).

19777. (a) If a taxpayer has been contacted by the Franchise Tax Board regarding the use of a potentially abusive tax shelter, and has an underpayment of tax, there shall be added to the tax an amount equal to 100 percent of the interest accrued under Section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the date the notice of proposed assessment is mailed.

(b) “Potentially abusive tax shelter” means:

(1) Any tax shelter (as defined in Section 6111 of the Internal Revenue Code) with respect to which registration is required under Section 6111 of the Internal Revenue Code.

(2) Any entity, investment plan or arrangement, or other plan or arrangement which is of a type that the Secretary of the Treasury or the Franchise Tax Board determines by regulations as having a potential for tax avoidance or evasion.

(c) The penalty imposed by this section is in addition to any other penalty imposed under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23000), or this part.

(d) This section shall apply to notices of proposed assessments mailed after the effective date of the act adding this section.

19778. (a) For any amended return filed after March 31, 2004, and before the taxpayer is contacted by the Internal Revenue Service or the Franchise Tax Board regarding a potentially abusive tax shelter, then, for taxable years beginning after December 31, 1998, with respect to any understatement of tax related to using reportable transactions as defined in Section

1 18407, as added by the act adding this section, the taxpayer is
2 subject to interest as provided under Section 19101 but at a rate of
3 150 percent of the adjusted annual rate established under Section
4 19521.

5 ~~SEC. 13.~~—

6 *SEC. 12.* Section 21028 of the Revenue and Taxation Code is
7 amended to read:

8 21028. (a) (1) With respect to tax advice, the protections of
9 confidentiality that apply to a communication between a client and
10 an attorney, as set forth in Article 3 (commencing with Section
11 950) of Chapter 4 of Division 8 of the Evidence Code, shall also
12 apply to a communication between a taxpayer and any federally
13 authorized tax practitioner to the extent the communication would
14 be considered a privileged communication if it were between a
15 client and an attorney.

16 (2) Paragraph (1) may only be asserted in any noncriminal tax
17 matter before the Franchise Tax Board.

18 (3) For purposes of this section:

19 (A) “Federally authorized tax practitioner” means any
20 individual who is authorized under federal law to practice before
21 the Internal Revenue Service if the practice is subject to federal
22 regulation under Section 330 of Title 31 of the United States Code,
23 as provided by federal law as of January 1, 2000.

24 (B) “Tax advice” means advice given by an individual with
25 respect to a state tax matter, which may include federal tax advice
26 if it relates to the state tax matter. For purposes of this
27 subparagraph, “federal tax advice” means advice given by an
28 individual within the scope of his or her authority to practice
29 before the federal Internal Revenue Service on noncriminal tax
30 matters.

31 (C) “Tax shelter” means a partnership or other entity, any
32 investment plan or arrangement, or any other plan or arrangement
33 if a significant purpose of that partnership, entity, plan, or
34 arrangement is the avoidance or evasion of federal income tax or
35 the avoidance or evasion of the tax imposed under Part 10
36 (commencing with Section 17001) or Part 11 (commencing with
37 Section 23001).

38 (b) The privilege under subdivision (a) does not apply to any
39 written communication between a federally authorized tax
40 practitioner and any person, or any director, officer, employee,

1 agent, or representative of the person, or any other person holding
2 a capital or profits interest in the person in connection with the
3 promotion of the direct or indirect participation of the person in
4 any tax shelter (as defined in Section 1274(b)(3)(B) of the Internal
5 Revenue Code, as modified by subdivision (g) of Section 19164),
6 or in any proceeding to revoke or otherwise discipline any license
7 or right to practice by any governmental agency.

8 (c) This section shall be operative for communications made on
9 or after the effective date of the act adding this section.

10 (d) This section shall remain in effect only until January 1,
11 2005, and as of that date is repealed, unless a later enacted statute,
12 that is enacted before January 1, 2005, deletes or extends that date.

13 ~~SEC. 14. Section 24344.7 is added to the Revenue and~~
14 ~~Taxation Code, to read:~~

15 ~~24344.7. (a) Section 163 of the Internal Revenue Code,~~
16 ~~relating to deduction for interest, is modified to provide that no~~
17 ~~deduction is allowed under this part for any interest paid or accrued~~
18 ~~on any underpayment of tax that is attributable to either of the~~
19 ~~following:~~

20 ~~(1) The portion of any reportable transaction understatement~~
21 ~~(as defined in subdivision (b) of Section 19773) with respect to~~
22 ~~which the requirement of Section 6664 of the Internal Revenue~~
23 ~~Code, as modified by subdivision (d) of Section 19164, is not met.~~

24 ~~(2) Any noneconomic substance transaction understatement~~
25 ~~(as defined in subdivision (e) of Section 19774).~~

26 ~~(b) This section shall apply to transactions in taxable years~~
27 ~~beginning on or after the effective date of the act adding this~~
28 ~~section.~~

29 ~~SEC. 15.—~~

30 *SEC. 13.* (a) Unless otherwise provided, this act shall apply
31 with respect to any penalty assessed on or after January 1, 2004,
32 on any return for which the statute of limitations on assessment has
33 not expired. All other provisions of this act shall apply on and after
34 January 1, 2004.

35 (b) Except as provided in subdivision (c), Sections 18407,
36 19772, and 19773 of the Revenue and Taxation Code, as amended
37 or added by this act, applies to taxable years beginning on or after
38 January 1, 2003.

39 (c) (1) Sections 19775 and 19776 of the Revenue and Taxation
40 Code, as added by this act, apply beginning on January 1, 1999.

1 (2) For persons to which Section 19775 or 19776 apply,
2 Sections 18407 and 19772 of the Revenue and Taxation Code, as
3 amended or added by this act, apply beginning on January 1, 1999.

4 (3) *For purposes of applying Section 19778 of the Revenue and*
5 *Taxation Code, Section 18407 of the Revenue and Taxation Code,*
6 *as added by this act, applies for taxable years beginning after*
7 *December 31, 1998.*

8 (4) For the period January 1, 1999, to December 31, 2003,
9 inclusive, the return required under Section 19775 or the list
10 required under Section 19776 of the Revenue and Taxation Code,
11 as added by this act, shall not be due or requested prior to April 30,
12 2004.

